United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-7258

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT.

B

P/S

IRVING MASON, on Behalf of Himself and All Others Similarly Situated, and Derivatively on Behalf of C. I. REALTY INVESTORS,

Appellant,

v.

CITY INVESTING COMPANY, C. I. REALTY INVESTORS, C. I. PLANNING CORPORATION, WILLIAM POLK CAREY, JOHN L. GIBBONS, PETER C. R. HUANG, JAMES V. TOMAI, JR., ROBERT M. MORGAN, WILLIAM S. RENCHARD, FRED R. SULLIVAN, JAMES R. WEBB, and REYNOLDS SECURITIES, INC.,

Appellees.

On Appeal From the United States District Court for the Southern District of New York.

BRIEF FOR APPELLANT.

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IN THE

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No. 76-7258.

IRVING MASON, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED, AND DERIVATIVELY ON BEHALF OF C. I. REALTY INVESTORS,

Appellant,

v.

CITY INVESTING COMPANY,
C. I. REALTY INVESTORS,
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WILLIAM S. RENCHARD,
FRED R. SULLIVAN,
JAMES R. WEBB, AND
REYNOLDS SECURITIES, INC.

Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-APPELLANT.

PRELIMINARY STATEMENT.

This appeal taken by Irving Mason arises from an Order (dated May 3, 1976) by Judge Inzer B. Wyatt of the United States District Court for the Southern District of New York, dismissing two counts of appellant, Irving Mason's complaint which alleged, *inter alia*, violations of Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") derivatively on behalf of C. I. Realty Investors (the "Trust"). These derivative causes of action were dismissed for failure to make a demand on the shareholders of the Trust as required by Massachusetts law. After making an express determination that there is no just reason for delay, the Court entered a final judgment against appellant pursuant to Rule 54(b) of the Federal Rules of Civil Procedure, and this appeal followed on May 27, 1976 (App. 92a).

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW.

Appellant presents the following issues for review:

Whether the District Court erred in holding that a shareholder of a Massachusetts corporation or business trust must first make a demand on all of a corporation's shareholders before being permitted to assert derivative claims on behalf of the corporation where:

1. The derivative claims are grounded on federal law—the Securities Exchange Act of 1934—and pendent state claims.

2. Such a requirement would be impossibly and unreasonably burdensome and would conflict with the federal policy underlying the securities laws of the United States.

3. And the law of the transferor forum, which must be applied pursuant to *Van Dusen v. Barrack*, 376 U. S. 612 (1964), holds that it is not reasonable to require a demand on the shareholders of a publicly held corporation or business trust as a condition precedent to bringing a derivative suit.

STATEMENT OF THE CASE.

On February 25, 1975 appellant Irving Mason (plaintiff below) filed a six count derivative and class action complaint in the United States District Court for the Eastern District of Pennsylvania alleging violations of various provisions of the federal securities laws, as well as pendent state law claims (App. 4a).

On March 20, 1975 Judge Newcomer of the Eastern District of Pennsylvania ordered this action transferred to the United States District Court for the Southern District of New York pursuant to 28 U. S. C. Section 1404(a).

The defendants named in the amended complaint are in addition to the Trust, (1) City Investing Company ("C. I. C.")—a corporation which controls the Trust, the Trust's advisor, and several of its Trustees; (2) C. I. Planning Corporation ("Planning Corp.")—an indirectly wholly-owned subsidiary of C. I. C. which served as advisor to the Trust; (3) William Polk Carey—a Trustee of the Trust as well as a Vice-President and Director of Corporate Finance for DuPont Glore Forgan, Inc., one of the two managing underwriters of the Trust's public offering; (4) John L. Gibbons—a Trustee of the Trust since April 3, 1972 and a director and member of the executive committee of C. I. C.; (5) Peter C. R. Huang—the Chairman of the Trust's board of trustees and an executive Vice-President of C. I. C.; (6) James V. Tomai, Jr.—President, Chief Executive Officer, and Trustee of the Trust, as well as President of the Trust's Advisor (Planning Corporation) and President, Chief Executive Officer, and Trustee of C. I. Mortgage Group, another trust controlled by C. I. C. and Planning Corp.; (7) Robert M. Morgan—a Trustee of the Trust as well as Vice Chairman and Trustee of C. I. Mortgage Group; (8) William S. Renchard; (9) Fred R. Sullivan; (10) James R. Webb—all of whom were Trustees of the Trust since April

3, 1972; and (11) Reynolds Securities, Inc.—one of the two managing underwriters of the Trust's public offering of April 13, 1972.

Through its April 13, 1972 public offering, the Trust raised approximately $65,000,000 by selling 2,600,000 Units of the Trust's securities to the public at $25.00 per Unit. Each Unit contained one share of beneficial interest in the Trust and one warrant to purchase an additional share at $25.00. On April 13, 1972, appellant Mason purchased 1,000 Units of the Trust for $25,000. The market value of each of the Trust's shares has since declined drastically, and they are presently trading at approximately $3.25 per share. The warrants are generally regarded as being worthless at this time.

The Trust is a Real Estate Investment Trust organized pursuant to Massachusetts law under a declaration of trust dated November 10, 1971 as amended on April 3, 1972 (App. 40a). The shares of the Trust are registered with the Securities and Exchange Commission pursuant to Section 12 of the Exchange Act. The Trust's shares have been traded on the over-the-counter market and, since December 12, 1973, on the New York Stock Exchange (App. 5a).

Counts I, II and III of the Amended Complaint allege class action claims for violations by the defendants of Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 13a-1, 13a-11, and 13a-13 promulgated thereunder, as well as Sections 12(2) and 17(a) of the Securities Act of 1933 ("Securities Act") in connection with the preparation of the registration statement and issuance of the prospectus for the public offering of the Trust's shares commencing April 13, 1972. Count VI alleges class action claims for violations of state law against all defendants except the Trust and Reynolds Securities, Inc. Counts I, II, III and VI are collectively referred to as the class action counts. Count IV alleges violations of Sections 10(b) and

14(a) of the Exchange Act and Rules 10b-5 and 14a-9 promulgated thereunder, derivatively on behalf of the Trust against all of the defendants except Reynolds Securities, Inc. Count V alleges violations of the state fraud, self-dealing, conflict of interest and breach of fiduciary duty laws derivatively on behalf of the Trust against all of the defendants except Reynolds Securities, Inc. Counts IV and V are collectively referred to as the derivative counts.

The defendants, on December 12, 1975, moved: (1) to stay all proceedings in connection with the class action counts pending a final determination of *Steinberg v. Carey*, also pending in the Southern District of New York, 75 Civ. 1965 (I. B. W.) which alleges class action claims for violations of Section 10(b) of the Exchange Act and Rule 10b-5 against substantially the same defendants and for similar acts; (2) to dismiss the derivative counts for failure to make a proper demand on the shareholders of the Trust; and (3) to dismiss the derivative counts on the grounds that plaintiff cannot properly maintain a suit derivatively on behalf of the Trust at the same time he is prosecuting direct claims against the Trust.

On May 3, 1976, the District Court entered an order which stayed the class action claims until there was a final determination of the related case of *Steinberg v. Carey* and dismissed the derivative counts solely on the grounds that plaintiff failed to make a demand upon the shareholders of the Trust as required by Massachusetts law. The Court further entered a final judgment in favor of the defendants as to the derivative counts pursuant to Rule 54(b) of the Federal Rules of Civil Procedure [1] (App. 92a).

On May 27, 1976 Mason filed this appeal from the Court's dismissal of the derivative counts of his amended complaint (App. 94a).

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1. The Court's order staying prosecution of plaintiff's class action counts is not presented to this court on appeal.

ARGUMENT.

I. The District Court Erred in Dismissing the Derivative Claims Alleging Violations of the Securities Exchange Act of 1934 for Failure to Make a Proper Demand on the Trust's Shareholders, as No Such Demand Is Required.

In his order and final judgment of May 3, 1976, Judge Wyatt of the United States District Court for the Southern District of New York, dismissed Counts IV and V of Mason's Amended Complaint "on the grounds that plaintiff has failed to make a demand upon the shareholders of defendant C. I. Realty Investors as required by Massachusetts law." While there is some authority for the proposition that appellant may have been required under Massachusetts state law [2] to make a demand on the shareholders of the Trust before instituting a derivative action, *e.g.*, *S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp.*, 326 Mass. 99, 93 N. E. 2d 241 (1950), appellant respectfully submits that the great majority of federal court decisions on this point hold otherwise stating that regardless of what the relevant state law is, it will not control over the federal securities laws, or that the state's shareholder demand requirement will not apply where it is an unreasonable requirement because of the tremendous burden and expense involved.[3]

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2. The Trust was organized as a business Trust pursuant to Chapter 182, as amended, of the General Laws of Massachusetts. Mass. Ann. Laws C. 182 Section 1, et seq. (1969).

3. Plaintiff contends that the only demand requirement conceivably relevant herein is the demand on the Trustees or Directors. However, plaintiff's complaint clearly alleges why such demand was not made before instituting this action. See Par. 27, Am. Cmplt. at 28a. In addition on February 17, 1976, plaintiff did in fact make a demand on the Trustees to bring suit. In any event, this issue was not raised in the District Court by the defendants (Tr. 76a).

A. State Corporate Law Which Conflicts With the Overriding Federal Interest in the Protection of the Investing Public Cannot Control.

In discussing the intent of Congress in passing the various federal securities laws including the Exchange Act,[4] upon which Count IV of appellant's Complaint is grounded --the Supreme Court stated that:

> "[All of these statutes were] designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. . . . A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, 'it requires but little appreciation * * * of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."

S. E. C. v. Capital Gains Research Bureau, 375 U. S. 180, 186-7 (1963) (citations omitted). *Accord, Affiliated Ute Citizens of Utah v. United States*, 406 U. S. 128 (1972). It is thus well settled that, as with all remedial legislation, the Exchange Act is to be liberally construed to effectuate its purposes--central of which is the protection of the investing public through the disclosure requirement as well as strong civil and criminal penalties to prevent and punish fraud. *E.g., Affiliated Ute, supra; Tcherepnin v. Knight*, 389 U. S. 332 (1967); *Crane v. Westinghouse Air Brake Co.*, 419 F. 2d 787 (2d Cir. 1969), *cert. denied*, 400 U. S. 822 (1970); *Columbia General Investing Corp. v. S. E. C.*, 265 F. 2d 559 (5th Cir. 1959).

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4. 48 Stat. 881, as amended, 15 U. S. C. Section 78a *et seq.*

Moreover, the Supreme Court has held that in light of this overriding Congressional concern with the protection of the investing public embodied in the Exchange Act, the federal courts are free to fashion appropriate remedies to effectuate this congressional purpose despite the contrary provisions of state corporate law which may limit the nature of available remedies. *J. I. Case Co. v. Borak*, 377 U. S. 426 (1964). In holding that the Exchange Act authorizes a federal cause of action for rescission or damages, the court in *J. I. Case Co., supra*, expressly stated that if victims of deceptive proxy statements were obliged to seek relief in the state courts, the purpose of Section 14 of the Exchange Act would be frustrated if the state either attached no responsibility to the use of misleading proxy statements or placed various procedural hurdles which could "well prove insuperable to effective relief." *Id.* at 434-5.

These reservations expressed by the Supreme Court would apply with even more force if these state procedural or substantive hurdles (such as mandatory demand on the stockholders in all cases) were held to apply under Rule 23.1 to derivative suits in federal court under the federal securities laws. Indeed, all of the court-mandated liberal construction would be of no avail to derivative plaintiffs if, as the District Court's order would suggest, any one state or group of states could frustrate the purpose of these statutes by enacting burdensome conditions precedent to the maintenance of derivative suits.

Furthermore, it is unrealistic to claim that since a stockholder's right to sue derivatively on behalf of his corporation arises from the generosity of state law, that the "necessity" under Rule 23.1 [5] of a demand on the body of

5. Rule 23.1 only requires a demand on the shareholders "if necessary." This "if necessary" qualification has been interpreted as referring the federal court to the substantive law upon which the

stockholders would also depend on state law. Rather, it is just the opposite, for as this Court has noted, the stockholder's derivative suit and the limitations upon its use were initially developed by the federal courts as part of their powers as courts of equity. *Fielding v. Allen*, 181 F. 2d 163, 167-8 (2d Cir.), *cert. denied sub nom., Ogden Corp. v. Fielding*, 340 U. S. 817 (1950). *Accord, McClure v. Borne Chemical Co.*, 292 F. 2d 824, 832-34 (3d Cir.), *cert. denied*, 368 U. S. 939 (1961); *see Hawes v. City of Oakland*, 104 U. S. 450 (1882). Indeed, a shareholder's right to "maintain a derivative action on a corporate right federal in nature is federally conferred." *Fielding, supra; McClure, supra.* Mindful of the overriding federal interest in obtaining a high standard of business ethics in the securities industry as well as the equitable origin of the derivative suit in federal court, the overwhelming number of courts which have decided this issue have held that the demand on the stockholders requirement embodied in state law will not control where that law would harm the federal interests receiving expression in the derivative right sought to be enforced. *Levitt v. Johnson*, 334 F. 2d 815 (1st Cir. 1964), *cert. denied*, 379 U. S. 961 (1965); *Phillips v. Bradford*, 62 F. R. D. 681 (S. D. N. Y. 1974); *Jannes v. Microwave Communications, Inc.*, 57 F. R. D. 18 (N. D. Ill. 1972); *see Dopp v. American Electronic Lab's, Inc.*, 55 F. R. D. 151 (S. D. N. Y. 1972).

A decision directly on point with the issues raised by the instant appeal was rendered by the First Circuit Court of Appeals in 1964. There, the court which encompasses the Commonwealth of Massachusetts was presented with

5. (Cont'd.)
suit is grounded—that is federal law in the instant case. *Jannes v. Microwave Communications, Inc.*, 57 F. R. D. 18 (N. D. Ill. 1972); 7A Wright & Miller, Federal Practice and Procedure: Civil Section 1832 at 385 (1972).

the identical issue of whether plaintiffs in a derivative lawsuit were required, under Rule 23.1 of the Federal Rules of Civil Procedure, to make a demand on the shareholders of a Massachusetts corporation before bringing suit under the federal securities laws. The court held that such demand was not required despite the provisions of Massachusetts law. *Levitt v. Johnson*, 334 F. 2d 815 (1st Cir. 1964), *cert. denied*, 379 U. S. 961 (1965).

The Court in *Levitt* distinguished its earlier decision of *Halprin v. Babbitt*, 303 F. 2d 138 (1st Cir. 1962) (holding that the minority must demand upon the majority), as follows: "In Halprin . . . 92% of the company's stock was held by one stockholder. We were not, in other words, speaking in the context of 48,000 stockholders, or as to when such a circumstance might constitute an excuse." 334 F. 2d at 817. Most importantly, the court further stated that: "Nor does Halprin, which was a diversity case, answer the question of what law presently governs." 334 F. 2d at 817.

The court specifically disapproved of the lower court's holding that state law applies "even if the claim which the corporation has against the alleged wrongdoer is based on a federal statute." Indeed, the First Circuit in *Levitt* specifically held that Massachusetts state law was irrelevant:

> "We need not pursue the inquiry of whether the Massachusetts law is otherwise, because if it is, it should not, in our opinion, be applied." 384 F. 2d at 819.

Recognizing the important congressional policy underlying the securities laws, the *Levitt* court held that it could "not see how it can be gainsaid that any substantial stiffening of the conditions precedent to the bringing of stockholders' suits above normal requirements would conflict with this

broad declaration [of national policy]." 334 F. 2d at 819. As the court continued:

> "The district court's reasoning that since the stockholder's right is a derivative one, his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation. See Note, 50 Va. L. Rev. 365 (1964)." 334 F. 2d at 819.

In so holding, the *Levitt* court relied on the Supreme Court's decision in *J. I. Case Co. v. Borak, supra,* where in it was held that:

> "[W]e believe that the overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law . . ." 377 U. S. at 434.

The First Circuit thus clearly held that Massachusetts state law—requiring a shareholder demand—could not control in derivative suits grounded on the federal securities laws. This decision by the Court in *Levitt* has been followed by most of the courts which have considered this issue since 1964. *Phillips v. Bradford,* 62 F. R. D. 681 (S. D. N. Y. 1974); *Jannes v. Microwave Communications, Inc.,* 57 F. R. D. 18 (N. D. Ill. 1972); *Dopp. v. American Electronic Lab's, Inc.,* 55 F. R. D. 151 (S. D. N. Y. 1972); *see Milstein v. Werner,* 54 F. R. D. 228 (S. D. N. Y. 1972); *Weiss v. Sunasco, Inc.,* 316 F. Supp. 1197 (E. D. Pa. 1970); *Kane v. Central American Mining & Oil, Inc.,* 235 F. Supp. 559, 568 (S. D. N. Y. 1964). In addition, the *Levitt* decision has received widespread acceptance by the com-

mentators.[6] The District Court, therefore, erred in applying Massachusetts law in the instant case.

Senior Judge Robson (then Chief Judge), was presented with the same issue in *Jannes v. Microwave Communications, Inc.*, 57 F. R. D. 18 (N. D. Ill. 1972). In *Jannes* the parties disagreed as to whether Illinois law required a demand on shareholders. The court refused to even consider Illinois law holding:

> "The parties discuss at some length whether Illinois law would require a demand on the shareholders under the circumstances of this suit, but this court is of the opinion that federal common law controls. Although speaking of whether a federal cause of action was created by violation of Section 14(a) of the Securities Exchange Act, the comment of the Supreme Court is that '. . . the overriding federal law applicable here would, where the facts required, control the appropriateness of redress despite the provisions of state corporation law, for it "is not uncommon for federal courts to fashion federal law where federal rights are concerned." ' J. I. Case Co. v. Borak, 377 U. S. 426, 434, 84 S. Ct. 1555, 1561, 12 L. Ed. 2d 423 (1964). *Furthermore, one reason that federal jurisdiction is necessary in order to effectuate the Securities Exchange Act is to avoid state law hurdles which 'might well prove insuperable to effective relief.' Id.* at 435, 84 S. Ct. at 1561. In connection with Sec.

6. *E.g.*, Note, 78 Harv. L. Rev. 1476 (1965); Note, 50 Va. L. Rev. 365 (1964) (criticizing the lower court decision in Levitt since overturned by the First Circuit). *See also, Bromberg*, Fraud-SEC Rule 10b-5 Section 11.7 (1975); Bloomenthal, Securities and Federal Corporate Law, Section 11.20[2] (1974); 7A Wright & Miller, Federal Practice and Procedure: Civil Section 1832 (1972); 13 Fletcher Cyc. Corp. Section 5970 at 385 (1970 Revised Ed.); Loss, Securities Regulation, Vol. II at 951 (1961), as supplemented, Vol. V at 2920 (1969); Carey, Cases on Corporations, 4th Ed. at 341 (1969).

> 14(a) there is authority that whether a shareholder demand is necessary is 'clearly' a matter of federal law. 2 Loss, Securities Regulation 951 (1961). This court can discern no reason why Section 10(b) should be interpreted differently from Section 14(a) of the same act." 57 F. R. D. at 22 [Emphasis added].

The court concluded by citing the First Circuit's decision in *Levitt v. Johnson,* 334 F. 2d 815 (1st Cir. 1964) and held that:

> "*This court holds that federal law does not require a shareholder demand as an element of a derivative action for a corporation seeking redress for violations against it of positive federal law, i.e., the Securities Exchange Act.*" 57 F. R. D. at 22 [Emphasis added].

Similarly, in *Phillips v. Bradford,* 62 F. R. D. 681 (S. D. N. Y. 1974), Judge (now Circuit Judge) Gurfein also held that no shareholder demand was necessary, stating:

> "Since this action is brought under the Investment Company Act of 1940, we need not look to state law to determine whether a demand on the shareholders is necessary. [*Levitt v. Johnson*] * * *
>
> Moreover, since the shareholder could not ratify the alleged violations of federal law, no demand is required. [*Dopp v. American Electronic Laboratories, Inc.*]" 62 F. R. D. at 688.

This court's decision in *Brody v. Chemical Bank,* 482 F. 2d 1111 (2d Cir. 1973), *cert. denied,* 414 U. S. 1104 (1973), is not to the contrary. That case was very similar to *Halprin v. Babbitt,* 303 F. 2d 138 (1st Cir. 1962) which was distinguished by the Court in *Levitt v. Johnson, supra,* on the grounds that in *Halprin,* "92% of the company's stock

was held by one stockholder. We were not in other words, speaking in the context of 48,000 shareholders. . . ." Similarly in *Brody,* an action brought by a preferred shareholder, all of the corporation's common stock was owned by one shareholder, and, furthermore, this one common shareholder was managed by independent court-appointed bankruptcy trustees.[7]

Moreover, in an earlier opinion discussing an analogous issue—that of standing to sue—a panel from this court held, using language appropriate to the present case, that an equitable shareholder did have standing to bring an action under Section 10(b) of the Exchange Act. *Drachman v. Harvey,* 453 F. 2d 722 (2d Cir. 1971), *aff'd in part and rev'd in part on other grounds,* 453 F. 2d 736 (1972) (*en banc*). In speaking for the panel, Judge Lumbard stated that:

> "More significantly, we are concerned here with an important enforcement provision of a federal statute intended not only to expand the common law but to create new, far-reaching and uniform law of shareholder-management relations in congressionally designated areas of substantive corporation law,

7. It should also be noted that the applicable state law at issue in *Brody,* which this court has approved, was that of Delaware which holds that a shareholder demand is unnecessary where the wrongs complained of (fraud or illegality) are beyond the power of ratification by a majority of the shareholders. *Brody* at 1114 citing *Mayer v. Adams,* 37 Del. Ch. 298, 141 A. 2d 458 (Sup. Ct. 1958). Thus the *Brody* Court was not faced with the situation presented in this case where an affirmation of the District Court's order would allow one state to frustrate the policy of the federal securities laws by placing an unreasonable condition precedent upon plaintiffs bringing derivative suits. Plaintiff respectfully submits, therefore, that the Court's reliance in *Jones v. Equitable Life Assurance Soc'y.,* CCH Fed. Sec. L. Rptr. [1974-5 Transfer Binder] Par. 94,986 (S. D. N. Y. Feb. 14, 1975), on *Brody v. Chemical Bank* for the holding that a demand is required under Massachusetts law was misplaced.

> *which must not under the Supremacy Clause of the Constitution be subordinated to or otherwise hindered by the interposition of state requirements and limitations inconsistent with overriding federal policy.*" 453 F. 2d at 729 [Emphasis added and footnotes omitted].

See generally, Maternally Yours v. Your Maternity Shop, 234 F. 2d 538, 540-1 (2d Cir. 1956), where this court held in oft-quoted language that: "[I]t is the *source* of the right sued upon, and not the ground on which federal jurisdiction over the case is founded which determines the governing law." Furthermore, two recent decisions of this Court reiterate the theory of *Levitt v. Johnson,* 334 F. 2d 815 (1st Cir. 1964) and *J. I. Case Co. v. Borak,* 377 U. S. 426 (1964), that state law will not be permitted to conflict with the effectuation of the federal securities laws and the actions based thereon. *Marshel v. AFW Fabric Corp.,* 533 F. 2d 1277 (2nd Cir. 1976), *Petition for cert. filed,* 44 U. S. L. W. 3720 (U. S. June 8, 1976) (No. 75-1782); *Green v. Santa Fe Industries, Inc.,* 533 F. 2d 1283 (2nd Cir. 1976), *Petition for cert. filed,* 44 U. S. L. W. 3720 (U. S. June 6, 1976) (No. 75-1753).

Indeed, *Levitt v. Johnson,* and its progeny are hardly unique to the corpus of federal law. Rather, these cases (*Levitt, Phillips,* and *Jannes*) are merely a handful of the overwhelming number of federal court decisions which have held that federal law and not state law (including the various provisions of a state's general corporation law) will be applied where the cause of action is founded on the federal securities laws. For example, it is well settled that state security for expense laws do not apply in derivative suits grounded on the federal securities laws. *E.g., Borak v. J. I. Case Co.,* 317 F. 2d 838 (7th Cir. 1963), *aff'd on other grounds,* 377 U. S. 426 (1964); *McClure v.*

Borne Chemical Co., 292 F. 2d 824 (3d Cir. 1961), *cert. denied*, 368 U. S. 939 (1961); *Fielding v. Allen*, 181 F. 2d 163 (2d Cir.), *cert. denied sub. nom., Ogden Corp. v. Fielding*, 340 U. S. 817 (1950). In holding state law to be irrelevant, the court in *McClure* stated, in language relevant to the instant case, that:

> "What is more important, we do not believe that Sections 10(b) and 29(b) of the Securities Exchange Act should be construed as being superimposed upon the stockholder-management relationship defined by state security for expenses statutes, since the federal provisions are a part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations and which, therefore, may not be subordinated to limitations such as security for expenses statutes, reflecting state policy in the same area.
>
> * * *
>
> [S]tate law will only control where that law will not cut across the federal interests receiving expression in the federal right sought to be enforced.
>
> * * *
>
> In the present case we are construing two sections of the Securities Exchange Act of 1934. That Act deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. Section 10(b) imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 and Section 29(b), Section

> 10(b) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act, of which Sections 10(b) and 29(b) are parts, constitutes far reaching federal substantive corporation law.
>
> * * *
>
> Where a unique and controversial state doctrine alters relationships that are the principal concern of a federal statute that doctrine will not be applied to limit rights arising under the federal statute. Thus state interest in the present suit must be subordinated to the federal policy occupying the same field. We conclude, therefore, that the question whether security for expenses may be required in the present case must be resolved by reference to federal law." 292 F. 2d at 834-5.

In addition to state shareholder demand requirements and security for expenses laws, the federal courts have held other provisions of state law to be inapplicable or irrelevant to actions grounded on the federal securities statutes. *E.g., Green v. Santa Fe Industries, Inc., supra* (Rule 10b-5 cause of action exists in short form merger situation despite state corporate law making appraisal the exclusive remedy); *Wolf v. Frank*, 477 F. 2d 467 (5th Cir. 1973), *cert. denied*, 414 U. S. 975 (1973) (allowance of prejudgment interest with 10b-5 damage award); *Fields v. Fidelity Gen. Ins. Co.*, 454 F. 2d 682 (7th Cir. 1971) (dictum that a derivative 10b-5 action may be maintained despite the lack of authority to sue from state court supervising corporate liquidation); *Drachman v. Harvey*, 453 F. 2d 722 (2d Cir. 1971), *aff'd in part and rev'd in part on other grounds*, 453 F. 2d 736 (1972) (*en banc*) (standing of an equitable stockholder to bring a derivative

10b-5 action); *Clement A. Evans & Co. v. McAlpine*, 434 F. 2d 100 (5th Cir. 1970), *cert. denied*, 402 U. S. 988 (1971) (10b-5 civil action does not require the application of state substantive law of fraud); *Myzel v. Fields*, 386 F. 2d 718 (8th Cir. 1967), *cert. denied*, 390 U. S. 951 (1968) (election of remedies doctrine); *Gilson v. Chock Full O'Nuts Corp.*, 331 F. 2d 107 (2d Cir. 1964) (en banc—award of attorney fees for merely prompting corporation to bring an action under Section 16(b) of the Exchange Act); *Globus, Inc. v. Law Research Service, Inc.*, 318 F. Supp. 955, 958 n. 2 (S. D. N. Y. 1970) (contribution and indemnification for violations of federal securities laws), *aff'd*, 442 F. 2d 1346 (2d Cir.), *cert. denied*, 404 U. S. 941 (1971); *Ho[illegible] American Cone & Pretzel Co.*, 71 F. Supp. 266 (E. D. Pa. 1947) (non-interference with foreign corporation doctrine). Similarly, the courts have also held that the definition of the various terms used in the federal securities statutes are dependent on federal law and the policy underlying these statutes and not on the contrary provisions of state law. *E.g.*, *Tcherepnin v. Knight*, 389 U. S. 332 (1967); *Champion Home Builders Co. v. Jeffress*, 490 F. 2d 611 (6th Cir. 1974), *cert. denied*, 416 U. S. 986 (1974); *S. E. C. v. Sterling Precision Corp.*, 393 F. 2d 214 (2d Cir. 1968).

Appellant submits that the reasoning of the Third Circuit in *McClure v. Borne Chemical Co.*, *supra* 292 F. 2d at 824 applies with equal force in the present case, for the security for expenses and shareholder demand requirements both serve to define the stockholder-management relationship according to state law. These state laws, however, should not control where they cut across a federal statutory scheme designed to create a new federal law of management-stockholder relations. *Id.*, 292 F. 2d at 834-5. Indeed, even if this Court feels compelled,

[based on an analysis of the policy considerations reflected in the Exchange Act, *see* 7A Wright & Miller, *Federal Practice and Procedure:* Civil, Section 1832 at 385 (1972)], to adopt some type of shareholder demand requirement from among the various provisions of the laws of the fifty states, as a federal rule of decision,[8] it would be highly inappropriate to choose Massachusetts law since its harsh strictness flies in the face of the liberal and flexible treatment of the securities statutes mandated by the Supreme Court in *Affiliated Ute Citizens v. United States,* 406 U. S. 128 (1972), *Tcherepnin v. Knight,* 389 U. S. 332 (1967), and other cases. Moreover, Massachusetts law is further unsuited for adoption as a federal rule, as Massachusetts is unique among American jurisdictions in requiring a demand on shareholders in all cases—including those where fraud or violations of law are alleged.[9]

This Court's decision in *Brody v. Chemical Bank,* 482 F. 2d 1111 (2d Cir. 1973), which purports to look to state law in order to decide whether a demand on the shareholders is required, cannot be viewed as requiring the application of Massachusetts law in this case. Indeed, this Court in *Brody* raised the issue of Delaware state law on its own motion as further authority to support the plaintiff's position in *Brody* that no demand was required on Pennco's shareholders. Furthermore, the two cases relied

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[8] ...ules of Decision Act, 62 Stat. 94, 28 U. S. C. Section 1652. ...*ee,* Note, 43 N. C. L. Rev., 422, 443 (1965); Conrad, et al., Cas... Enterprise Organization, 752 (1973). The only other state to experiment with an equally strict rule was Ohio which judicially adopted the Massachusetts rule only to have the state legislature quickly reverse the court. *Claman v. Robertson,* 164 Ohio St. 61, 128 N. E. 2d 429 (1955), Legislatively reversed on January 1, 1956, Ohio Rev. Code, Section 2307.315, *renumbered,* Section 2307.311 (1976 Supp.). Additionally, federal courts have the right to reject state law in federal question cases if it is unusual or irregular or if there is a substantial conflict among the states. *E.g., McClure v. Borne Chemical Co., supra* 292 F. 2d at 830; *see* Note, 50 Va. L. Rev. 365, 370 (1964) and cases cited therein.

on by the *Brody* Court, *Gottesman v. General Motors Corp.*, 268 F. 2d 194 (2d Cir. 1959) and *Dopp v. American Elec. Lab's, Inc.*, 55 F. R. D. 151 (S. D. N. Y. 1972), also do not support the proposition that the strict Massachusetts demand requirement must be applied in this case, for in both *Dopp* and *Gottesman* the state law at issue was that of Delaware which, as discussed above (at p. 15 n. 7), does not conflict with the overriding federal interests embodied in the securities laws. More importantly, this Court (per chief Judge Clark) in *Gottesman* first held that no demand was required under general federal equity principles since it was unreasonable as well as futile to require a demand in the hundreds of thousands of General Motors shareholders; citing *Hawes v. Oakland*, 104 U. S. 450 (1882) and *Cathedral Estates v. Taft Realty Corp.*, 228 F. 2d 85 (2d Cir. 1955). Only afterwards did Chief Judge Clark raise the issue of Delaware law as further support for the plaintiff's position that no shareholder demand was required. Similarly in *Dopp*, Judge Weinfeld first held that, "No such demand is required where, as here, the shareholders could not ratify the alleged wrongs since they constituted violations of federal law." 55 F. R. D. at 155. Again, the issue of Delaware law which "does not require such a demand, at least in cases where illegality or fraud is alleged," was only raised as further support for the plaintiff's position that no shareholder demand was required. *Id.* Therefore the *Brody*, *Gottesman*, and *Dopp* decisions do not support the proposition that the strict Massachusetts demand requirement is applicable to the instant litigation. Indeed, the reasoning of these cases as well as that of the *Levitt v. Johnson*, 334 F. 2d 815 (1st Cir. 1964) and *J. I. Case Co. v. Borak*, 377 U. S. 426 (1964) courts clearly support appellant's position that the Massachusetts rule cannot apply to derivative suits grounded on federal statutes.

In light of the authority referred to above, appellant respectfully submits that state laws requiring demand on shareholders before institution of a derivative lawsuit do not apply to this action which has its basis in the federal securities laws.

B. As a Matter of Federal Law, a Demand on the Shareholders of C. I. Realty Investors Is Not Required, as It Would Be Unreasonably Burdensome to Require It, and, Furthermore, Appellant's Complaint Alleges Violations of Federal Law.

Appellant submits that even if this Court finds that federal law does not completely override Massachusetts state law, the Massachusetts law requiring a demand on shareholders before the institution of a derivative lawsuit should not apply to this action because of the large number of shareholders involved, the expense and effort required, the difficulties inherent in such a demand and the unlikelihood of intra-corporate settlement.

As a matter of federal law, a shareholder demand is not required under Rule 23.1 where it is unreasonable to require it. Rule 23.1, as a creation of Equity,[10] was not intended to force a plaintiff to undertake a purely ritualistic act. *Delaware & Hudson Co. v. Albany & S. R. R.*, 213 U. S. 435 (1909); *Gottesman v. General Motors Corp.*, 268 F. 2d 194 (2d Cir. 1959); 7A Wright & Miller, Federal Practice and Procedure: Civil Section 1832 at 387 (1972). Such a demand requirement has been held to be unreasonable if the alleged wrongdoer(s) held a majority or working control of the corporation's stock. *E.g. Delaware & Hudson Co. v. Albany & S. R. R. supra; Cathedral Estates v. Taft Realty Corp.*, 228 F. 2d 85 (1955). Most

10. *Hawes v. Oakland*, 104 U. S. 450 (1882). *See generally, Fielding v. Allen, supra* 181 F. 2d at 167-8.

importantly, the cases hold that where the number of shareholders is large, no demand is required on the shareholders. *Gottesman v. General Motors Corp.*, 268 F. 2d 194 (2d Cir. 1959); *Accord, Levitt v. Johnson*, 334 F. 2d 815 (1st Cir. 1964); *Weiss v. Sunasco*, 316 F. Supp. 1197 (E. D. Pa. 1970). While there are courts that have rejected this unreasonably burdensome argument, *e.g., Haffer v. Voit*, 219 F. 2d 704 (6th Cir. 1955), *cert. denied*, 350 U. S. 832 (1955), these cases involved state law claims, and, therefore, their holdings are quite inappropriate for actions based on the federal securities laws. *Levitt v. Johnson, supra; Gottesman v. General Motors Corp., supra.* Indeed, it would be highly paradoxical if those public shareholders who are clearly within the protective scope of the federal securities laws would be thwarted in seeking a redress of their rights merely because there are so many other public shareholders who are equally within the protective scope of this legislation.[11] In the words of the First Circuit in *Levitt:*

> "Nowhere has this been better stated than in the opinion of the district court in Pomerantz v. Clark, D. Mass. 1951, 101 F. Supp. 341, where it was said at 346, 'To prevent these minority members from suing until they have acquired the support of a ma-

11. It is no longer open to doubt that private actions (including derivative actions brought on behalf of a corporation) seeking redress for security law violations are an integral part of the regulatory scheme—supplementing the action of a heavily burdened S. E. C. *E.g., Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S. 6 (1971); *J. I. Case Co. v. Borak, supra* 377 U. S. at 432; *Mills v. Electric Auto-Lite Co.*, 396 U. S. 375 (1970); *Ruckle v. Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964); *Hooper v. Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir. 1960), *cert. denied*, 365 U. S. 814 (1961). *See* Carey, Cases on Corporations 4th Ed. at 300 (1969) (stating that, "the S. E. C. is not staffed to examine the mountain of 1934 material with the same precision as a 1933 filing.").

> jority of their fellows is in most cases to throttle them. They must move against inevitable inertia which always favors the *status quo*, the respectable and the powerful, particularly if regardless of wrongdoing, a particular company has prospered. They rarely have large funds at their command to circularize and arouse their fellows. And, above all, they are not in a position to state the details of wrongdoing which would persuade unprejudiced men until after they have brought suit and had the advantage of testimonial compulsion.' See also, Baker & Cary, Cases on Corporations (3d ed. 1959), p. 233: 'Statistics demonstrate that in most instances shareholder proposals receive a minimal percent of the total votes case.' Newcomer, The Big Business Executive, (1955), p. 9: 'In a corporation whose stock is widely distributed the possibility of dissatisfied stockholders mustering the necessary votes to force a change is very slim. It is easier to sell the stock. The cost alone is prohibitive, as was made abundantly clear in the recent New York Central upset. The cost of this proxy battle was estimated to be more than one million dollars. [Citing Fortune] Only when the dissatisfied minority has really important holdings, as in the case of the New York Central, is the chance of getting a new deal a real one.'" 334 F. 2d at 818 n. 3.

Since the corporation involved in the lawsuit in *Lovitt* had 48,000 shareholders, the First Circuit rejected the strict Massachusetts rule as propounded by that state's Supreme Judicial Court in *Solomont & Sons Trust, Inc., supra*, and other cases, on the grounds that, in addition to being inapplicable to suits grounded on federal law, it was also a pointless and impossibly burdensome act which should be excused. 334 F. 2d at 818; *accord, Gottesman*

v. General Motors Corp., supra, 268 F. 2d at 197. Indeed, the *Levitt* court expressly distinguished *Solomont & Sons* by holding that there is no valid purpose that could possibly be served by requiring a demand on the shareholders of a widely held corporation since it is highly unlikely that these thousands of widely scattered shareholders could ever intelligently discuss the affects of the lawsuit on their company's business affairs—which is, supposedly, one of the major rationales for the demand requirement in the first place. In the words of Judge Aldrich in *Levitt:*

> "Solomont did not involve the present question, but decided solely that a majority of disinterested stockholders could vote that an action against the directors, even though valid, should not be pursued. The district court concluded that this meant that Massachusetts would not excuse a demand on the majority stockholders, unless, following the directors' analogy, they were not disinterested. *We do not believe this follows. The fact that a majority of informed disinterested stockholders might decide, for reasons discussed in Solomont, that a suit should not be prosecuted, does not mean that they must be fully instructed in every instance before the suit is instituted.* As we pointed out in Halprin v. Babbitt, supra, the minority does not have to obtain the express authorization of the majority before suit is commenced. The demand upon the majority, in other words, does not have this broad purpose. Neither of the more limited purposes [for the demand requirement] we outlined in Halprin could be accomplished in any real sense unless the demand evoked a full and fair consideration of the issues, in depth, by the other stockholders. If their number is small, as

> in Halprin, and the minority could reasonably be expected to put its case before them, it should be obliged to do so. *However, on the allegations of the present complaint not only would such a burden be enormous, but no disclosure that plaintiff could be expected to make would be likely to persuade a majority to take over the action, or, conversely permit an informed, decision by the majority that the action be not instituted.*" *Levitt v. Johnson*, 334 F. 2d 815, 818 (1st Cir. 1964) [Emphasis added and footnotes omitted].

Therefore, with the rationale of the Massachusetts rule completely undermined by the very existence of a large number of shareholders, the First Circuit held that as a futile and unavailing ritual which forced the plaintiff minority shareholder to entail prohibitive expenses as well as undue loss of time this demand requirement would be excused under Rule 23.1. *Accord, Gottesman v. General Motors Corp., supra; see Hawes v. City of Oakland, supra.*

Similarly, in *Weiss v. Sunasco, Inc.*, 316 F. Supp. 1197 (E. D. Pa. 1970), Judge Fullam of the Eastern District of Pennsylvania, without considering the requirements of state law, held that a demand on the stockholders of a publicly held corporation was not required by Rule 23.1 of the Federal Rules of Civil Procedure regardless of whether the derivative claim was based on federal law or state common law. After reviewing the history of the requirements of Rule 23.1,[12] Judge Fullam further stated that:

> "The strongest support for plaintiff's position [that a demand need not be made on Sunasco's shareholders where the record indicated that there were

12. Discussing *Hawes v. City of Oakland*, 104 U. S. 450 (1882); and *Surowitz v. Hilton Hotels Corp.*, 383 U. S. 363 (1966).

> 3,666,985 shares outstanding although the number of individual stockholders was unknown] is *Levitt v. Johnson,* 334 F. 2d 814 (1st Cir. 1964). There the Court clearly stated that in the case of a publicly-owned corporation with 48,000 shareholders it was not necessary to seek prior shareholder action before institution of a derivative shareholders' suit." 316 F. Supp. at 1207.

After reviewing two decisions of this Court,[13] which expressed the view that a plaintiff is not required to seek prior shareholder action if the named defendants own a substantial, but not necessarily controlling portion of the stock, and the remaining shareholders are numerous and widely dispersed, Judge Fullam concluded his *Sunasco* decision on a practical note that applies with equal force to the present case:

> "In determining whether or not the policies underlying Rule 23.1 will be served, and whether it is reasonable to require resort to shareholder action prior to the institution of suit, it is important to consider the type of intra-corporate remedy available. For instance, in this case even if the board of directors were to be replaced, the cause of action against the ousted directors would presumably then be pursued by the corporation. There would still be a lawsuit pending against the named defendants in this case." 316 F. Supp. at 1207.

Recognizing that there were over 3,600,000 shares of the defendant corporation outstanding and thus (it could be

13. *Meltzer v. Atlantic Research Corp.,* 330 F. 2d 946 (2d Cir. 1964), *cert. denied,* 379 U. S. 841 (1964); *Gottesman v. General Motors Corp.,* 268 F. 2d 194 (2d Cir. 1959).

assumed) a large number of shareholders, Judge Fullam held:

> "Having in mind the expense and effort necessary to bring the issues raised in this action before the shareholders of a publicly held corporation of this size, the difficulties inherent in any attempt to replace an incumbent board, and the likelihood of intra-corporate settlement, I have concluded that it would be unreasonable to require resort to the shareholders as a condition precedent to this derivative action. As the Supreme Court pointed out in Delaware & Hudson Co. v. Albany and Susquehanna Railroad Co., 213 U. S. 435, 29 S. Ct. 540, 53 L. Ed. 862 (1909):
>
> > 'Rule 94 [a predecessor of the present Rule 23.1] is intended to have practical operation, and to have that it must, as to its requirements, be given such play as to fit the condition of different cases.' " 316 F. Supp. at 1207.

The exact situation present in *Levitt v. Johnson,* 334 F. 2d 815 (1st Cir. 1964) and *Weiss v. Sunasco, Inc.,* 316 F. Supp. 1197 (E. D. Pa. 1970), is present here. None of the "limited purposes" of the demand requirement could be accomplished here. There are almost 8,000 [14] shareholders of the Trust, and the burden of a demand would be enormous. *Compare Levitt v. Johnson, supra,* and *Weiss v. Sunasco, Inc., supra; with Halprin v. Babbitt,* 303 F. 2d 138 (1st Cir. 1962); *and Brody v. Chemical Bank,* 482 F. 2d 1111 (2d Cir. 1973). *See also, Berg v. Cincinnati N. & Co. Ry.,* 56 F. Supp. 842 (E. D. Ky. 1944); Note, 30 U. Cin. L. Rev. 196, 207 (1961). Moreover, any demand on the

14. Annual Report—dated February 28, 1975. It is not clear whether this refers to shareholders of record only or whether it also includes beneficial shareholders which would make the number of shareholders even higher than the 8,000 reported (Tr. 70a).

shareholders of C. I. Realty Investors would constitute a solicitation under the rules of the Securities and Exchange Commission [15] and thus in making such a demand plaintiff Mason would have the additional burden of complying with the Commission's rules on proxy solicitations [16] including, among other requirements, filing several copies of the preliminary and definitive material with the Commission. Rule 14a-6. It is absurd to suggest that a plaintiff must first comply with a highly complex set of administrative rules before he may bring suit under federal or state law. *See Gottesman v. General Motors Corp.*, 171 F. Supp. 661 (S. D. N. Y. 1959), *appeal dismissed*, 268 F. 2d 194 (2d Cir. 1959). Therefore, as a pointless or, alternatively, complex and impossibly burdensome act, demand should be excused. *Levitt v. Johnson, supra; Gottesman v. General Motors Corp.*, 268 F. 2d 194 (2d Cir. 1959); *Weiss v. Sunasco, Inc., supra.*

Moreover, even assuming, *arguendo*, that any demand in the instant case would not be impossible to achieve, and assuming that appellant, after communicating with 8,000 people, could obtain a "full and fair consideration of the issues" by these 8,000 individuals, a demand on the Trust's shareholders would still be unnecessary, as the shareholders could not ratify a violation of federal law nor could they prevent a derivative suit charging violations of federal law. As Chief Judge Clark stated in *Gottesman v. General Motors Corp.*:

> "A shareholders' vote cannot prevent the institution of a derivative suit or annul one once it has been brought; had that been possible it is obvious that very few such suits could or would have been maintained.

15. Rule 14a-1(f), 17 C. F. R. Section 240.14a-1(f).

16. Rules 14a-1 to 14a-11 and Schedule 14A, 17 C. F. R. Section 240.14a-1 to Section 240.14a-11 and Section 240.14a-101.

> At best a ratification by the body of shareholders merely compels the minority shareholder plaintiffs to shift slightly the legal theories on which they rely so as to raise charges of fraud, waste of corporate assets, or the like.
>
> * * *
>
> "*In the instant case even this slight effect on the litigation cannot occur, since the wrongful acts alleged*—violations of the antitrust laws by Du Pont—*can in no way be ratified or rectified by a vote of the shareholders of General Motors.*" 268 F. 2d at 197 [Emphasis added].

Accord, Rogers v. American Can Co., 305 F. 2d 297 (3d Cir. 1962); *Phillips v. Bradford*, 62 F. R. D. 681, 688 (S. D. N. Y. 1974); *Shulman v. Ritzenberg*, 47 F. R. D. 202 (D. D. C. 1969); *see Mayer v. Adams*, 37 Del. Ch. 298, 141 A. 2d 458 (Sup. Ct. 1958); *Continental Securities Co. v. Belmont*, 206 N. Y. 7, 99 N. E. 138 (1912). Therefore, due to the nature of the illegal acts alleged in appellant's Complaint, the demand on the Trust's shareholders should have also been excused as an unavailing and empty ritual.

In light of the authority referred to above, appellant submits that either as an unduly burdensome and inequitable requirement or as a futile and unavailing ritual the demand on the shareholders in the instant case should have been excused by the District Court.

C. The Strict Massachusetts Demand Requirement Cannot Apply in Cases Grounded on the Federal Securities Laws or Where the Number of Shareholders Is Large Since This Would, as a Practical Matter, Emasculate Federal and State Law Against Securities Violations and Fraud.

Appellant submits that as a general federal rule no demand should be required where violations of federal law are alleged or where the number of individuals owning stock is large. Indeed, if the District Court is upheld and the strict Massachusetts demand requirement[17] is held to attach itself to derivative suits based on federal law (suits which can be brought only in Federal Court, 15 U. S. C. Section 78aa) or to derivative suits involving widely held corporations, the directors and officers of any publicly held corporation could avoid almost all liability or even the most egregious violations of federal law,[18] as long as the injury was directly to the corporation, by simply having the corporation or trust reincorporate itself in Massachusetts. This result, which would effectively emasculate the "overriding policy of the federal law as well as that of most other states' laws which hold that even a majority of disinterested shareholders may not ratify fraud, is clearly not consistent with the policy of the federal securities laws. *E.g., Levitt v. Johnson,* 334 F. 2d 815 (1st Cir. 1964); *McClure v. Borne Chemical Co.,* 292 F. 2d 824 (3d Cir. 1961); *Shulman v. Ritzenberg,* 47 F. R. D. 202 (D. D. C. 1969). *Compare, Mayer v. Adams,* 37 Del. Ch. 298, 141 A. 2d 458 (Sup. Ct. 1958); *Continental Se-*

17. Massachusetts as discussed above is unique among American jurisdictions in requiring a demand on shareholders in all cases including those where fraud or illegality is alleged.

18. Including raping the corporate treasury of funds obtained in connection with the sale of securities in its portfolio. *See, Superintendent of Insurance v. Bankers Life & Casualty,* 404 U. S. 6 (1971).

curities Co. v. Belmont, 206 N. Y. 7, 99 N. E. 138 (1912). *See also* N. Lattin, Corporations, 2nd ed. at 418 (1971).

Furthermore, as some authorities have suggested, the federal securities laws form a basic part of a substantive "federal corporation law" which was intended to fill the gap left by the state legislatures which increasingly enacted statutes favorable to corporate management in an effort to attract corporations to their respective states. *See Green v. Santa Fe Industries, Inc., supra; Drachman v. Harvey, supra,* 453 F. 2d at 729; *McClure v. Borne Chemical Co., supra;* Carey, Cases on Corporations, 4th ed. at 9-15, 712-13 (1969). The District Court's result would as a practical matter reopen this gap and would, in addition to subverting the federal securities laws, place further pressure on the various state legislatures to outdistance each other in enacting liberal, pro-management laws. *See,* Note, 78 Harv. L. Rev. 1476, 1477 (1965), (stating that it would be anomalous to make private actions under the federal securities laws subject to state rules that tend to insulate abuses that these acts were designed to regulate).

II. The Law of the Transferor Forum Which Holds That No Demand on the Shareholders Is Required, Regardless of State Law, if Such a Demand Requirement Is Burdensome Must Be Applied.

A. The Transferee District Court Must Apply the Law of the Transferor Forum.

It is well settled that if a case is transferred pursuant to 28 U. S. C. Section 1404(a), the law of the transferor forum, not the transferee forum, must apply. *Van Dusen v. Barrack,* 376 U. S. 612, 639 (1964):

> "We conclude . . . that in cases such as the present where the defendants seek transfer, the trans-

> feree district court must be obligated to apply the state law that would have been applied if there had been no change of venue. A change of venue under Section 1404(a) generally should be, with respect to state law, but a change of courtrooms."

Even before *Van Dusen, supra,* this Court had mandated the same rule. In *H. L. Green Co. v. MacMahon,* 312 F. 2d 650, 653 (2d Cir. 1962), *cert. denied,* 372 U. S. 928 (1963), a decision expressly cited with approval by the Supreme Court in *Van Dusen,* Judge Lumbard held that regardless of whether a case has been brought in federal court under diversity of citizenship jurisdiction or under federal question jurisdiction, the transferee court must apply the law of the transferor forum.

Indeed, it is not just the transferor forum's state law which must be applied but also the transferor forum's federal substantive law which must be applied. In *In re Plumbing Fixtures Litigation,* 342 F. Supp. 756 (J. P. M. L. 1972), the State of North Carolina brought an action under Section 4 of the Clayton Act (15 U. S. C. Section 15). The state opposed any transfer under 28 U. S. C. Section 1407 fearing that the transferee court would interpret the standing requirements of Section 4 of the Clayton Act less favorably to antitrust plaintiffs than the transferor district and circuit and would thus dismiss the state's complaint as it (the transferee court) had done in similar cases in the past. The Judicial Panel on Multidistrict Litigation held that: "In our view these fears are groundless. It is clear that the substantive law of the transferor forum will apply after [the] transfer." 342 F. Supp. at 758. Though the *Plumbing Fixtures Litigation* decision involved a Section 1407 transfer situation in which an interpretation of a federal statute was at issue, the Panel

cited *Van Dusen v. Barrack*, and its statements relating to Section 1404(a) transfers as authority for its holding.[19] This court relied on the *Plumbing Fixtures* decision in *Berry Petroleum Co. v. Adams & Peck*, 518 F. 2d 402, 408 (2d Cir. 1975) where it held that the degree of culpability or scienter needed to prove a violation of Section 10(b) and Rule 10b-5 would be judged under the transferor forum's law. *Accord, Stirling v. Chemical Bank*, 382 F. Supp. 1146 (S. D. N. Y. 1974) (standing to sue under the Exchange Act), *aff'd per curiam*, 516 F. 2d 1396 (2d Cir. 1975); *In re Four Seasons Securities Laws Litigation*, 370 F. Supp. 219 (W. D. Okla. 1974); *Philadelphia Housing Authority v. American Radiator Standard Sanitary*

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19. As applied in practice, Sections 1404(a) and 1407 are often identical in result. *In re Antibiotic Antitrust Actions*, 333 F. Supp. 299, 301 (S. D. N. Y. 1971), *petition for writ of mandamus denied, sub nom., Pfizer, Inc. v. Lord*, 447 F. 2d 122 (2d Cir. 1971) (where the Section 1407 transferee Judge held that the issues presented for trial including overlapping and conflicting claims were so complicated that "they can only be satisfactorily resolved by a coordinated or consolidated trial or trials in one district directed by the Judge who is most familiar with this massive litigation." i.e. the same judge who presided over the consolidated pretrial proceedings under Section 1407. *Accord*, Rule 11(b) of the Rules of Procedure of the Judicial Panel on Multidistrict Litigation, 65 F. R. D. 253 at 261 (1975) (allowing, *inter alia*, the Section 1407 transferee court to retain for all purposes under either 28 U. S. C. Sections 1404(a) or 1406 the various cases assigned to it under 28 U. S. C. Section 1407); Manual for Complex Litigation, Sections 5.02, 5.22-5.30 (1973); *In re Master Key Antitrust Litigation*, 70 F. R. D. 23 (D. Conn. 1975) (Section 1407 transferee court retained and consolidated for trial all but two cases), *appeal dismissed*, 528 F. 2d 5 (2d Cir. 1975); *In re Penn Central Commercial Paper Litigation*, 62 F. R. D. 341 (S. D. N. Y. 1974) (and cases cited therein), *aff'd mem.*, 515 F. 2d 505 (2nd Cir. 1975); *In re Career Academy Antitrust Litigation*, 57 F. R. D. 569 (E. D. Wisc. 1972) (". . . experience with the Multidistrict Litigation Act suggests that return [to the courts of the cases' inception] is often unnecessary in practice,"); *In re Koratron*, 302 F. Supp. 239, 242 (Jud. Pan. Mult. Lit., 1969) (per Wisdom, J. "Sections 1404(a), 1406(a), and 1407 are not mutually exclusive. . . .").

Corp., 309 F. Supp. 1053 (E. D. Pa. 1969) (holding that the law of the transferor district must apply).

Therefore, regardless of whether a cause of action is based on state or federal law and regardless of whether a transfer to a different federal district court is based on Section 1404(a) or Section 1407(a) of the Judicial Code, it is clear that the transferee court must apply the substantive law of the transferor state, circuit, or district. *E.g., Van Dusen v. Barrack, supra; Berry Petroleum, supra; H. L. Green Co. v. McMahon, supra; In re Plumbing Fixtures Litigation, supra.* Indeed the instant case is analogous to the North Carolina antitrust suit in *In re Plumbing Fixtures Litigation*, 342 F. Supp. 756 (J. P. M. L. 1972) for in both cases a change in the interpretation of the relevant federal substantive law would result in a dismissal of the complaint without even a cursory examination of the merits. In both cases a defendant's motion to transfer would be tantamount to a motion to dismiss for lack of standing due to a failure to comply with the transferee court's interpretation of a federal statute or substantive rule. *See Van Dusen, supra*, 376 U. S. at 630. It is this aspect of those cases involving transfers within the federal court system which the Supreme Court sought to preclude in its *Van Dusen v. Barrack* opinion where it held that:

> "There is nothing, however, in the language or policy of Section 1404(a) to justify its use by defendants to defeat the advantages accruing to plaintiffs who have chosen a forum which, although it was inconvenient, was a proper venue.
>
> * * *
>
> "We believe, therefore, that both the history and purposes of Section 1404(a) indicate that it should be regarded as a federal judicial housekeeping measure,

dealing with the placement of litigation in the federal courts and generally intended, on the basis of convenience and fairness, *simply to authorize a change of courtrooms.*" *Id.* at 633-34, 636-37 [emphasis added].

Therefore, appellees cannot get a change of federal law as a bonus to the change of venue that occurred herein, and the District Court erred in failing to apply the law of the transferor forum in the instant litigation. *Id.* at 636; *see Berry Petroleum, supra; In re Plumbing Fixtures Litigation, supra.*

B. The Transferor Forum Does Not Require a Demand on the Shareholders of a Massachusetts Business Trust Where Such a Demand Requirement Is Burdensome.

Since this action was originally brought in the Eastern District of Pennsylvania and subsequently transferred on March 20, 1975 pursuant to appellees Section 1404(a) transfer motion, the law that the courts of the Eastern District of Pennsylvania would apply should have been applied herein by the District Court. As is demonstrated at length *supra*, pp. 26-28, the courts of the Eastern District of Pennsylvania, after reviewing the applicable authority from the Court of Appeals for the First Circuit relating to Massachusetts law, hold that a demand on the shareholders of a corporation is not required by Rule 23.1 of the Federal Rules of Civil Procedure regardless of state law. *Weiss v. Sunasco, Inc.*, 316 F. Supp. 1197 (E. D. Pa. 1970).

In the instant case, as in *Weiss v. Sunasco, supra,* the exact number of shareholders of the Trust is unknown although it is approximately 8,000 individuals. Consequently, the Court in the Eastern District of Pennsylvania would not have required that plaintiff make a demand on

the Trust's shareholders under Rule 23.1 as a prerequisite to the maintenance of a derivative suit for violations of Rules 10b-5 and 14a-9. *Weiss v. Sunasco, supra. Accord, Meltzer v. Atlantic Research Corp.*, 330 F. 2d 946 (2nd Cir. 1964); *Gottesman v. General Motors Corp.*, 268 F. 2d 194 (2nd Cir. 1959); *cf., McClure v. Borne Chemical Co.*, 292 F. 2d 824 (3rd Cir. 1961). Therefore the District Court erred in dismissing the derivative counts of appellant's Complaint for failure to make a proper demand on the Trust's shareholders.

CONCLUSION.

On the basis of the foregoing, appellant respectfully requests this Honorable Court to reverse the order of the District Court dismissing the derivative counts for failure to make a demand on the Trust's shareholders.

Respectfully submitted,

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IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IRVING MASON, on behalf of himself and all others similarly situated and derivatively on behalf of C.I. Realty Investors,	:	No. 76-7258
Plaintiffs	:	
v.	:	
CITY INVESTING COMPANY, et al.	:	
Defendants	:	

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 5th day of August, 1976, I served by first-class mail, postage pre-paid two (2) copies each of the brief for Appellant and one (1) copy of the Appendix thereto upon: Mark L. Austrian, Esq., Davis, Polk & Wardwell, One Chase Manhattan Plaza, New York, New York 10005 and Weaver Gaines, Esq., Dewey, Ballantine, Bushby, Palmer & Wood, 140 Broadway, New York, New York 10005.

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Dated: August 5, 1976

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